Proskauer

Navigating the Club in Private Credit Deals

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In light of the recent rise in so-called liability management transactions in the middle market, described by some observers as “lender-on-lender violence”, now is a perfect time for middle market lenders to review and freshly consider their approach to interlender issues. These issues can be particularly difficult to navigate in club deals – financings provided by a group of two to four unaffiliated lenders – in which lenders often have greater hold sizes and less liquidity to trade their positions than in the syndicated loan markets.

This part of the debt market, perhaps more than any other, is built upon relationships. Direct lenders who participate in club deals tend to transact repeatedly with the same private equity sponsors (as owners of their borrowers) and lending partners, and often cite varying degrees of familiarity and trust with these counterparties. These relationships confer many benefits, which may include increased deal flow, transparency, and speed and certainty of execution. Perhaps the most significant advantage frequently discussed in the industry is that these relationships will discourage parties in these credits from effectuating the types of coercive transactions that occur with more frequency in the syndicated loan and bond markets. Without discounting the power of these relationships, this article will turn a critical eye toward the most common contractual rights that exist between the parties.

The observations in this article are based generally upon the collective experience of the Proskauer Private Credit Group and particularly upon a recent thorough review of approximately 50 representative middle market credits (of the more than 600 active credits in our database) for the data points referenced herein and related interlender provisions.

The Deal Lead

A single lender will often be awarded the largest allocation and informal title of deal lead when it has offered to provide the greatest amount of capital, agreed to the most accommodating terms, enjoys the strongest relationship with the private equity sponsor that owns or is purchasing the borrower, or has distinguished itself from the competition in a combination of these or other relevant factors. Consider some key data points regarding deal leads and allocations:

- The deal lead's hold size (aggregate loans and commitments as a percentage of all loans and commitments) averages:
    - 60.8% in 2 lender deals,
    - 54.7% in 3 lender deals, and
    - 53.3% in 4 lender deals.
- In 3 and 4 lender deals, the deal lead virtually always holds greater than forty percent of all initial loans and commitments, and holds greater than half of all initial loans and commitments in 64% of such deals.
- The average ratio between the hold size of the deal lead and the lender with the second largest hold size is:
    - 1.6 to 1.0 in 2 lender deals, and
    - 2.1 to 1.0 in 3 and 4 lender deals.

The deal lead exerts more control over credits than the other lenders in a variety of ways, some of which are hard to measure, including by influencing terms, choosing precedent documentation, and selecting counsel. However, we will focus on the most tangible aspects of the lead lender role (which also happen to be the most relevant during a work-out): the discretion given to the lead lender (or an affiliate) under credit documentation in its role as agent or arranger, and the relative voting rights of the lenders in the club to consent to modifications to the loan documents.

Deal Lead Discretion as Agent or Arranger

One of the many advantages enjoyed by the lead lender is that if it so elects, the Borrower will appoint the lead lender (or its affiliate) to agency and arranger roles under the credit documentation. When the lead lender assumes the role of administrative agent, collateral agent and/or lead arranger, in addition to the customary associated duties – administration of notices and payments, perfection of liens, execution of ancillary documentation, etc. – it also will take on discretion over certain decision-making. The scope of this discretion can vary quite materially from deal to deal in the middle market, with agents in certain cases enjoying the ability to make many unilateral decisions that would otherwise require the consent or direction of Required Lenders.

For example, in 10% of the deals we surveyed, the definition of consolidated net income or EBITDA includes an add-back for additional amounts approved by the agent (or another titled entity associated with the lead lender). If, and for so long as, the agent is an affiliate of lenders that constitute Required Lenders, then such a provision is largely form over substance and may expedite approvals through a single entity. However, if the approval of Required Lenders would otherwise necessitate one or more additional lenders' consent – which was the case in each of the deals in our data set – such provision is quite significant and provides the lead lender the *de facto* discretion to waive or forbear upon a financial covenant default or permit an incremental debt incurrence.

A common point of agent discretion that often serves as a bellwether for others is the ability of the agent to unilaterally exercise rights and remedies during the existence of an event of default. While the agent is always required to exercise rights and remedies when expressly directed to do so by Required Lenders, we found that in 63% of deals the agent is also permitted, in its sole discretion, to exercise rights and remedies without any such direction. When present, this right generally covers the gamut of remedies, from the charging of default rate interest to termination of commitments, acceleration and foreclosure on collateral.

One check on the ability of the agent to wield its discretionary rights is the Required Lenders' authority to remove and replace the agent. However, it may come as a surprise to some that in the same representative set of deals, less than 5% of credit agreements permit the Required Lenders (or even all lenders) to remove the agent under any circumstances (and that right is typically only effective during a continuing event of default). In the vast majority of deals, the agent may only be replaced if it voluntarily resigns its role.[1]

Unfortunately for minority lenders in a club deal, who are often less familiar with the credit documentation than the lead lender, are time constrained, do not typically have a right to expense reimbursement for separate counsel, and rely upon their reputation as a cooperative partner for allocations, such instances of agent discretion may be difficult to identify in the documents and even more difficult to successfully have changed. An overriding provision, either inserted in the credit agreement or documented in a side letter, that requires the agent or arranger to consult with or receive the approval of another lender to take material discretionary action can be used to solve for these issues, but presents its own challenges: for one, it is susceptible to differing interpretations as to which actions require consultation and, secondly, it could have the unintended consequence of slowing the agent in circumstances where all lenders would benefit from its ability to act quickly and of its own accord.

Required Lenders

"Required Lenders", referenced above, is the fundamental voting concept in all credit documentation that establishes which lenders' consent is necessary to effect a modification, waiver or consent, as well as to direct or approve certain actions (like the exercise of rights and remedies described above).

The simplest definition of Required Lenders is the Lender(s) holding a majority in amount of all outstanding loans and commitments (excluding from such calculation the loans and commitments held by defaulting lenders and lenders that are non-debt fund affiliates of the equity owners of the borrower) (the "***Standard Definition***"). In our market review, we found that about one-third of club deals include the Standard Definition. The Standard Definition is common in deals where the lead lender is the only lender that holds more than 40% of loans and commitments, and allows the lead lender to consummate Required Lender actions on its own.

Calling into question our nomenclature, the Standard Definition is not the most common definition of Required Lenders in our surveyed club deals. Nearly 60% of these credit agreements feature a Required Lenders definition that requires the consent of at least two unaffiliated lenders (so long as there are at least two such lenders) to approve any action (the "***Two or More Definition***"). The Two or More Definition is frequently used when the second lender has a hold size of 30% or more. Included in this group are deals that feature slight variations on the Two or More Definition, such as that at least two lenders are required so long as there are not more than four unaffiliated lenders, or that at least two lenders are required so long as there are two or more unaffiliated lenders that each hold at least some minimum share of loans and commitments.

A small minority of deals feature other bespoke variations of Required Lenders, and the two most common of these are tied to particular configurations of hold sizes:

- In deals with 3 or 4 lenders and a lead lender that holds less than 50% of aggregate loans and commitments at closing, it is common for the lead lender specifically to be a necessary part of any Required Lenders action so long as the lead lender does not materially reduce its hold size after the closing date.
- Similarly, in deals with 3 or 4 lenders, of which two each hold at least 35% of aggregate loans and commitments at closing, each of those two lenders may be a necessary part of any Required Lenders action so long as each such lender does not materially reduce its hold size after the closing date (the "***Two Named Lenders Definition***").

In short, the definition of Required Lenders in club deals is typically driven by the two lenders with the largest hold sizes. If the deal lead holds less than 50% – which is uncommon, occurring in less than 1 in 5 deals in our survey – it will push, often successfully, for a definition that makes it a necessary part of Required Lenders (at least initially). Of course, if the lead lender holds greater than 50%, it is always a necessary part of any Required Lenders action, and will seek the Standard Definition in most cases. The second lender will nearly always seek the Two or More Definition unless the allocations and deal dynamics are such that it can credibly argue for the even more advantageous Two Named Lenders Definition. Whether the second lender is successful in establishing an alternative to the Standard Definition is largely a function of two factors: its capital (both hold size and how necessary it is to completing the club) and its relationship with the borrower or its equity owner.

Increasingly common in the market is a provision in Required Lenders that excludes from the calculation thereof any loans that are subject to repurchase, either pursuant to a Dutch Auction (or similar pro rata offer) or in a non-ratable “open market purchase”. This provision is a response to concerns that exit consents that strip covenants and make other materially adverse changes to the credit agreement will be granted by Required Lenders as their loans are repurchased and rolled into priming facilities, as in a number of recent high profile cases. Interestingly, this term is present in the TriMark Credit Agreement and is cited by plaintiffs in that case in their breach of contract claims. While the inclusion of this term (in any form) offers substantially more protection to minority lenders than its absence, we note that as drafted in many credit agreements we have reviewed it is likely too narrow to completely eliminate the risk that it purports to address.

Sacred Rights

For any lender that is not a necessary part of a Required Lenders vote, the relative strength or weakness of so-called “sacred rights” – those few categories of modifications to the loan documents that require the consent of all lenders or all lenders adversely affected thereby – are of particular importance, as they represent the last line of defense against transactions that can be effected by Required Lenders and the borrower without the consent of minority lenders. The Loan Syndications and Trading Association’s (LSTA) form credit agreement establishes the market baseline for sacred rights, which can be summarized as protecting minority lenders’ right to the core economic terms of their loans (including principal amount, interest rate, payment dates, pro rata share and relative position within the waterfall) and the voting rights that they receive at closing.

In all cases, the strength of sacred rights varies materially depending on the nuances of the drafting in the credit agreement, and it would benefit minority lenders to review these provisions carefully with counsel. Pro rata sharing and waterfall sacred rights are probably the most notorious in this regard. Approximately 90% of the club deals we reviewed include both a sacred right that covers changes to the waterfall and a sacred right addressing pro rata provisions generally. In some credit agreements, most favorably drafted toward minority lenders, these provisions absolutely prohibit modifications to any provision in the loan documents that addresses the pro rata treatment of lenders or the priority of payments owed thereto, without the consent of each affected lender. In others, drafted to disfavor minority lenders, these protections are considerably narrower (for example, covering payments only, but not pro rata offers to repurchase loans) and diluted by a number of exceptions.

The NYDJ case is a useful illustration. NYDJ (a denim apparel company) was the borrower under a credit agreement with a single tranche of term loans. NYDJ and lenders holding a majority of the term loans agreed to an amendment whereby such majority lenders provided a new money term loan with a first-out repayment position, and concurrently such majority lenders' original term loans were moved up in the waterfall into a second-out position, leaving the minority lenders' original term loans in a subordinated third-out position. This was all effected within the existing credit agreement, exploiting unusually (but not uniquely) weak waterfall and pro rata sacred rights in the NYDJ credit agreement.

Certain more recent examples of amendments effected with the consent of Required Lenders to add priming facilities and roll-up existing loans into priority positions, such as Serta and Boardriders, have been effected in credits that contain more typical sacred rights – sacred rights that are substantively consistent with those in a majority of the deals we reviewed. These transactions utilize exceptions to the pro rata sacred right and the absence of a sacred right preventing subordination of debt to new incurrences or rolled-up obligations, each discussed in more detail below. Depending upon the outcome of these and similar disputes, we will either distinguish the typical sacred rights and related provisions from NYDJ as offering meaningfully more protection, or lump them together as susceptible to the same fundamental risks.

The consenting lenders and borrowers in most recent priming/roll-up transactions utilized a provision that permits the borrower to purchase loans on the open market and retire them. The open market purchase provision is an exception to the pro rata sacred right (no matter how drafted) now found in most middle market credits. What exactly constitutes an open market purchase, and whether it includes cashless debt exchanges only offered to certain lenders in the context of restructuring transactions, is one of the primary disputes in Serta, Boardriders and their ilk. But regardless of the exact bounds of that provision, these and other similar cases serve to remind lenders that middle market credit agreements today contain more technology (successfully pushed down market from the syndicated loan and high yield bond markets where they originated) providing flexibility to the borrower – provisions like refinancing facilities, debt exchanges, amend and extend, discounted loan buybacks and open market purchases – than at any time in the past. The utilization of these provisions does not require any lender approvals, and their ubiquity substantially narrows the list of non-ordinary course transactions useful in restructurings that require the consent of either Required Lenders or all lenders.

Most loan documents in the market today by their plain terms permit Required Lenders to approve or provide, in one form or another, a priming tranche of new money loans (on any terms and pricing to which they and the borrower may agree) that effectively subordinates all existing loans. To counter this risk, minority lenders have had some success in including a requirement that any amendment that subordinates the lenders' claims or the agent's liens on the collateral must be approved by all lenders (or all affected lenders), but such a sacred right appears in less than a third of the club deals in our survey (and in a significantly lesser share of all deals, as it is much rarer in single lender and syndicated financings). Recently, Borrowers' counsels have largely resisted the addition of this term, and in many financings proposed a compromise whereby subordination to new debt only requires an affected lender's consent to the extent that such lender was not offered an opportunity to provide its ratable share of the new priming facility.

Additionally, we reviewed credits with a host of uncommon (often bespoke) sacred rights, deployed situationally as appropriate, including the following:

- Compensation for all amendments, waivers and consents is required to be offered ratably to all lenders and paid to all consenting lenders. While this does not provide minority lenders with any additional voting rights, it does ensure that in most cases they are compensated for additional risk to the same extent as majority lenders.
- Lenders are protected by class, such that no class can be treated adversely relative to another class without the consent of holders of a majority of the adversely affected class.
- Minority lenders are protected from their commitments being changed from one class (such as delayed draw term loans) to another class (such as revolving commitments) without their consent.
- Certain specified provisions in the loan documents cannot be modified without the consent of all lenders, most frequently those relating to anti-layering (in second lien loans) and the terms and conditions pursuant to which the borrower, its equity owners, and their affiliates can purchase loans and commitments.

An additional consideration for minority lenders in club deals is that forbearances and the exercise of remedies are controlled by Required Lenders (and, as discussed above, sometimes the agent). Minority lenders can never cause the termination of commitments, acceleration, foreclosure on collateral or other steps to collect their loans during an event of default. This is true even during a payment default; so, while Required Lenders cannot waive or postpone any payment due to a lender without such lender's consent, they cannot be compelled to enforce the borrower's obligation to make any such payment.

Know Your Interlender Rights

At the outset of a deal, competitive dynamics often afford all lenders only limited negotiating power and a short period of time to review and comment on documents – documents which are more complex than ever before. Minority lenders are further disadvantaged by capped or no expense reimbursement and even less flexibility to comment. These realities can result in the nuanced interlender issues that are particularly acute in club deals being accorded less than due consideration. It is crucial that all lenders in the club, whether as deal lead or minority holder, enter each transaction with informed expectations, sufficient familiarity with relevant provisions and able counsel to ensure that they achieve a result that does not exceed their risk tolerance.

The importance of understanding and leveraging interlender rights in clubs is magnified in active credits facing the likelihood of default. Restructurings require an ability to quickly and deftly leverage documentary rights and avoid shortcomings during the negotiation process. The earlier and more thoroughly a lender reviews these provisions to identify restructuring opportunities and risks, the more time it will have to identify, analyze and weigh its alternatives, and the more likely it will be to ultimately realize its best possible outcome.

[1] This paragraph does not address the ability of the Borrower or certain lenders to remove the agent if it is a defaulting lender, affiliated with a defaulting lender, the subject of an agent-related distress event, or otherwise in material breach of its obligations under the loan documents; a removal right is more common under these circumstances.

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